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Preface

This book presents the results of Polish-Ukrainian scientific cooperation. It contains the papers prepared for the 10th international conference "Quantitative Methods in Accounting and Finance". Accounting and finance face nowadays many challenges. They require both an international and local approach, they need to be considered from the theoretical and practical point of view, and they also encourage general and specific analysis.

Support from quantitative methods is needed in order to discover, implement and verify new finance and accounting trends, methods and instruments. The research papers which are part of this book present different aspects of accounting and finance combined with a quantitative, in particular Econometric, approach.

Some of the papers focus on methodology of measurement, estimation and forecasting of financial phenomena, especially those related to investment processes. Others address specific problems of accounting such as accounting solutions for different branches, legal issues of accounting, responsibility and reporting. An alternative approach was also undertaken and the roles of a narrative and culture in accounting were presented.

The variety of papers selected for this issue ensures the complexity of the book. It provides theoretical as well as empirical material which can be used in further research and in business practice, particularly in accounting and finance. We hope that the content of the book provides a starting point for scientific discussion and practical changes.

Marta Nowak

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THE IMPACT OF THE IMPLEMENTATION OF SOLVENCY II ON THE FINANCIAL REPORTING OF INSURANCE COMPANIES IN POLAND

WPŁYW WDROŻENIA PROJEKTU SOLVENCY II NA SPRAWOZDAWCZOŚĆ FINANSOWĄ ZAKŁADÓW UBEZPIECZEŃ W POLSCE

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Summary: In view of the changing conditions of the financial market there is a need to change tools to assess the financial condition of insurers. That is why for several years there has been carried out preparatory work which will lead to the implementation in 2016 of the European insurers project called Solvency II. This project is intended primarily for the supervisory authorities of the insurance market to exercise more effective control, and thus also indirectly better protect customers of insurance services. The implementation of the Solvency II project entails a substantial modification of the scope of the accounting information. On the other hand, in Poland there is domestic legislation of accounting which is not always harmonized with Solvency II. This paper presents an analysis of the scope of information that are required when preparing reports for supervision, i.e. Solvency II and in the financial statements prepared according to Polish accounting law. Reports for Solvency II focus primarily on information about the level of capital SCR (Solvency Capital Requirement), or group of investments, reinsurance and liabilities. This approach results in a significant expansion of working people who prepare accounting data in insurance companies. Nearly 80% of insurers stated that they are fully ready for this implementation of Solvency II. Insurers in the Netherlands, the UK and Scandinavia declare the greatest progress in preparing it. Insurers in Poland assessed their preparedness as slightly less than 80%.

Keywords: Solvency II, Financial Reporting, Insurance.

Streszczenie: W związku ze zmieniającymi się uwarunkowaniami rynku finansowego zaistniała potrzeba zmiany narzędzi służących do oceny kondycji finansowej ubezpieczycieli. Dlatego też od paru lat prowadzone są prace przygotowawcze, które mają doprowadzić do wdrożenia w roku 2016 w europejskich zakładach ubezpieczeń projektu o nazwie Solvency II. Projekt ten ma służyć przede wszystkim organom nadzoru nad rynkiem ubezpieczeniowym do efektywniejszej kontroli, a przez to − również pośrednio – do lepszej ochrony klientów usług ubezpieczeniowych. Wdrożenie projektu Solvency II pociąga za sobą znaczną modyfikację zakresu informacji rachunkowych. W Polsce funkcjonują wewnętrzne regulacje prawne dotyczące rachunkowości, które nie zawsze są zharmonizowane z Solvency II. W artykule przedstawiono analizę zakresu informacji, które są wymagane podczas sporządzania raportów na potrzeby nadzoru, tj. Solvency II, oraz w ramach sprawozdań finansowych przygotowywanych według polskiego prawa bilansowego. Raporty Solvency II koncentrują się przede wszystkim na informacjach o poziomie kapitału SCR, czyli *Solvency Capital Requirement*, inaczej: grupują lokaty, reasekurację i zobowiązania. Takie podejście powoduje znaczne rozszerzenie pracy osób, które przygotowują dane rachunkowe w zakładach ubezpieczeń.

Słowa kluczowe: Solvency II, sprawozdawczość finansowa, ubezpieczenia.

1. Introduction

Insurance companies are the financial institutions in which special rules for financial reporting are required to use due to the specific activities. This is associated with the slightly different nature of their business. Financial products are an intangible dimension and are not valued for the balance sheet. Financial institutions have also a very strong developed investment activity, which is associated with products and achieved results. The activity of these entities is associated with risk management, too.

Insurance companies' regulations in Poland are applied primarily resulting from national, internal law regulations which also need to be adapted to the requirements of European financial markets. Financial institutions are also subject to financial supervision, which in Poland is represented by the Polish Financial Supervision Authority. The purpose of its activity is supervision, which should ensure the proper functioning of the market, stability, security and transparency, confidence in the financial markets, and ensure the protection of the interests of the market participants.

The financial services market is changing very rapidly and therefore it requires continuous modification in the regulation which would allow for its proper functioning. Therefore a European directive was created which aims at amending the rules governing the operation of the business of insurance. These actions are called Solvency II project. The implementation of this project involves the preparation of Polish insurers to make changes in the presentation of information in financial statements. The Solvency II project is thus linked to a revolution in the financial reporting of insurance companies.

The purpose of this article is to examine the changes that can be caused by the implementation of the Solvency II project in the area of the financial reporting of insurance companies operating on the Polish market. This project changes the scope of the statements and elaborates on the information system generated by the insurer. This is due to changes in the methods and standards for financial market supervision. The main task of the Solvency II project is to establish a new solvency regime for the insurance business which is based on taking into account the risk profile of the insurance company. The paper will present the main assumptions and the history of Solvency II, the Polish legal regulations concerning the financial statements published by the insurers, as well as will explain the role of supervision of the Polish insurance market. A key part of the article it will be a section devoted to the analysis of the changes that can cause Solvency II relative to the previously discussed adjustments.

The applied research methods will be based on carrying out a critical analysis of scientific sources and legislation on the subject addressed, as well as on analysing existing publications in this field.

The development and implementation of the Solvency II project on the Polish insurance market is the most important intervention in financial reporting for financial institutions since the introduction of new regulations in 1994. Therefore, for several years, scientists and practitioners, representatives of the insurers and supervisors, accountants and managers have been trying to answer the question "How big will this change be?".

The full implementation of Solvency II in Poland started in January 2016. However, there is a lot of preparatory work which began in April 2015.

2. The Solvency II Project

As a result of rapidly changing market conditions, which meant that the existing rules for the assessment of solvency and financial condition of insurance companies no longer serve their purpose, a project appeared which is called Solvency II. This is a part of a larger plan for activities in the field of financial services, which is called the Financial Services Action Plan and was published in the European Commission Document No. MARKT/ 2509/03 of March 2003 [Note Prepared by the Commission Services….].

The main change in the assessment of the activities of insurance companies concerns taking into account a much broader range of factors relevant to the solvency of insurers and the impact of various risks. The Solvency II project is to serve primarily the authorities supervising the insurance market to enable more effective control, and thus also indirectly better protect the customers of the insurance services. The implementation of the Solvency II project entails a substantial modification of the scope of the accounting information. Therefore, the appearance of these changes is not without significance for the financial reporting of insurance companies.

The most important changes in the context of Solvency II are based on seven basic assumptions [Website of Polish Financial...]. The first of these is that supervisors should have the appropriate tools for a comprehensive assessment of the insurance company in terms of solvency ("overall solvency"), which means that the new system, besides the quantitative factors, should also take into account the qualitative aspects of the activities such as management or internal control. Quantitative factors are much more explicit and easier to measure, but currently it is very hard to assess the activities of the entities without taking into account the qualitative aspects, because they are a frequent source of problems resulting from operational risk activities. "Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events" [Consultative Document…].

The second assumption is that the new system should encourage and motivate insurance companies to properly manage the risks to which they are exposed. The European Union Directive on Solvency II listed four types of risk in an insurance company. These are:

- underwriting risk,
- credit risk,
- market risk,
- operational risk.

Each of them comprises from six to eight detailed further components. The objective of Solvency II is therefore to implement a model that allows the evaluation of the activities of the insurer taking into account the actions of these risks such as risk pricing, product design risk and interest rate risk and risk management control.

The next assumption concerns the capital requirements which should be designed as a two-level: the Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR). Of particular note is the first one. The SCR is based on a Value-at-Risk measure calibrated to a 99.5% confidence level over a one-year time horizon. The SCR covers all risks an insurer faces (e.g. insurance, market, credit and operational risk) and will take full account of any risk mitigation techniques applied by the insurer (e.g. reinsurance and securitization). The SCR may be calculated using either a new European Standard Formula or an internal model validated by the Supervisory Authorities [http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf]. This design will give supervisory authorities the necessary time to take appropriate corrective action in the company.

In order to ensure consistency of approach across the financial sector, the Solvency II regime should be, where possible, compatible with the approach and rules adopted in the banking sector. This project takes into account the functioning of the financial services market financial conglomerates that create a series of coverage of capital, products, personnel between insurers, banks, funds and other institutions that offer various financial products. Therefore the next assumption is that the new system is aimed at the more effective supervision of insurance capital groups and financial conglomerates. This is a serious problem in financial markets, because so far these entities generally were evaluated separately, although the links between them are of great importance for a variety of strategic and operational decisions.

The penultimate assumption is that it is necessary to harmonize the European supervisory, accounting and reporting standards. Although the single market for financial services has been functioning for many years, it continues in many countries, such as Poland, overriding regulations resulting from the provisions of Polish law. They are not always 100% coordinated with European Union guidelines. This project is therefore also to unify the rules on supervision, accounting and reporting in all European countries.

The last assumption is that the Solvency II project is to be implemented in accordance with Lamfalussy's procedure which is used in the European Union to issue regulations governing the functioning of the financial sector. This procedure includes three levels of regulation [http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf].

From the perspective of this article, the most important role is played by the acts of the last level, which includes implementing technical standards which are European Commission regulations for direct application in member countries. The list of binding technical standards was set in the Omnibus II Directive of 15 July 2011. These rules govern the setting of the Solvency Capital Requirement, the valuation of assets and liabilities, the valuation of technical provisions, the level of own funds, as well as internal models to manage risks.

In Poland the Ministry of Finance is conducting further work on preparing a new law on insurance and reinsurance operations, which adjust the provisions of the Solvency II Directive into Polish law. In addition, the Polish Financial Supervision Authority is developing internal reporting forms which are to complement the requirements of Solvency II. They are dictated by the specific nature of the Polish market, and also are a source of information for statistical purposes.

3. The scope of the financial statements for insurance companies according to Polish regulations on accounting law

Insurance companies belong to the group of financial institutions which in Polish accounting law is treated as a separate group of entities. These institutions are characterized by the high specificity of the various financial positions in accounting, their different balance sheet structure and another way of determining the financial result. For a complete understanding of the information contained in the financial statements of these entities we are also required knowledge of the scope and nature of the insurance business. The most important features of insurance which affect the scope of its financial statements are [Ronka-Chmielowiec 2004, p. 241]:

– the intangible nature of the insurance product,
– the specific cost structure.

The balance sheet of an insurance company has a completely different structure from other companies because it stands a very large share of investments and the lack of inventory of assets and the presence of technical provisions in liabilities. In contrast, the financial result in the insurer determined the general profit and loss account, but on the basis of the technical account. For this position, reporting, there are differences between life and nonlife insurers. The first one, whose products have more investment character than the others associated with investment activities have the result of investment activities together with the result from the sale of the insurance technical account. On the other hand, non-life insurance companies whose products do not have the nature of the investment but purely insurance, presenting the result from investment activities separately from the technical account. This is the biggest difference between the two groups of insurers.

A characteristic feature of the technical account, regardless of the nature of the product, is that when it comes to determining the technical result in the first place income and expenses are taken, but they are additionally adjusted for change in technical provisions. This type of formula results in the insurer's financial results being shaped in a rather unique way. If sales are growing, its reserves have also increased, as to secure greater contributions resulting from the greater risks needed to raise the level of reserves. Otherwise, the opposite is that as sales fall, dropping the amount of the hedged risks, and therefore can be part of the reserves of resolve. The increase in reserves is considered by accounting principles as a cost, and the release of them as income.

In the case of insurance companies, elements of any additional information are very important relating to the portfolio of insured risks, the structure of investments, the amount of different types of technical provisions and the solvency margin and own funds.

A detailed explanation of the accounting policy for insurance companies is regulated by the recommendation of the Minister of Finance. This document describes regulations of:

- conducting the accounting records of insurance and reinsurance activity,
- accounting, insurance and reinsurance documents,
- specific rules for accounting for investments,
- specific rules for the creation of technical provisions,
- specific rules for preparing financial statements,
- consolidated financial statements of the group.

In addition, they are also connected to the regulation explanatory notes on the balance sheet preparation, technical and general account, cash flow statement and the scope of the notes. In the last part of the regulation there are more detailed rules of provisioning and determining the rate of return on investments.

This regulation is updated from time to time. The first document, the Accounting Act, is an act that has not been changed since 1994, except of course for some amendments and the regulations are published every few years. Currently, it is valid from 2009, with a slight change in 2015. The implementation of the Solvency II project forced the Polish legislature to change the rules after more than twenty years, which is why, as mentioned earlier, there is already a draft of the new law, but it is has not been yet approved, which is why there are not still fully binding legal regulations.

4. The role of the Supervision Authority in creating the financial reporting for insurance companies

Financial institutions due to the nature of its products, as well as the huge role they play in the economy through participation in the financial markets, are subject to supervision. Insurance supervision is “the activity of the exercise of custody by a state authority over the insurance market to ensure compliance by acting on the bodies of universally binding law and internal regulations” [Handschke, Monkiewicz 2010, p. 409]. The supervisory body is therefore an institution whose duty is to monitor and control the activities of insurance companies to protect the public and private interest. It should be added, however, that the main purpose of the supervisory authority is to check whether the insurer operates in accordance with specific regulations. Therefore, it is extremely important that the rules clarifying issues related to insurance activities have been formulated clearly and precisely.

In a world where there are different types of insurance supervision, the classification depends on the criterion according to which they are divided. From an accounting perspective, this is important criterion subject to supervision which extracts two models. These are [Handschke, Monkiewicz 2010, p. 414]:

– financial supervision,
– supervision based on risk control.

Financial supervision directs its interest primarily on the capital and financial management of the insurer and the assessment of this area in terms of solvency of an insurance estimate as the possibility of smooth regulation of the insurance liabilities. This model has been in force so far in the European Union. The second model is based on risk. Its aim is also to monitor the insurance business in terms of solvency, but it is associated with the risk profile of the insurer. This model has a much broader scope because it takes into account the capitals, but apart from that it takes into account other elements such as corporate governance, or the internal risk management system. A model based on risk control is currently being adopted by the European Union in the form of Solvency II. Therefore European countries are shifting from the financial model to one based on risk. It is therefore a very big change for regulation, not only supervision, but also other areas, such as e.g. financial reporting because insurance supervision is based on information derived from the accounting system.

Regulation and supervision are ”like twin brothers. They depend on each other. Regulation without an enforcement mechanism is simply powerless. Supervision, on the other hand, for its operation, requires a legal framework provided mainly by regulation” [The Geneva Papers… 2013, p. 4].

The Polish Financial Supervision Authority is also responsible for the implementation of Solvency II in Poland and supervises all work associated with it. It deals with carrying out investigations to be used to assess the effects of the implementation of this project. It is about checking whether the requirements imposed by Solvency II allow for more effective protection in the insurance market. These analyses involved part of the insurance companies that fill in prepared spreadsheets e.g. the method of calculating technical provisions. These results are compared with the existing methods used before Solvency II.

The Polish Insurance Supervision is based on recommendations of EIOPS, i.e. the European Insurance and Occupational Pensions Committee. The work of the

European Union on the harmonization of accounting has been underway for many years and resulted in the preparation of several directives. The first one was published in 1978, still within the European Community and concerned financial statements. The preparation of the Solvency II project is therefore the result of many years of work whose premise was to bring the greatest possible harmonization of accounting.

Solvency II is based on three pillars [Monkiewicz 2005, p. 143]:

- quantitative supervision,
- qualified supervision,
- market discipline.

From the point of view of accounting and financial reporting the most important is pillar I. It includes the quantitative capital requirements concerning not only the capital, but also the technical provisions and assets.

It is worth noting also that apart from the issue of Solvency II derived from the supervision area, there are also works in the area of accounting that result in the development of accounting standards and financial reporting. These standards must also be taken into account when implementing the Solvency II project. Noteworthy is, for example, the introduction of fair value which is very important for the valuation of assets of the insurance. It causes a change in policy and strategy in the sale of insurance. The fair value is in fact less predictable, which, in the the structure of assets based on investments is very dangerous.

5. Changes due to the implementation of the Solvency II project

The Solvency II project is ready to improve the supervisory activities of the insurance market, which is why its main purpose is to obtain information that will help in assessing the solvency of the insurer. These are regulations that have origins in accounting law, and therefore reporting of insurance companies operating in a two-track. On the one hand, the insurer must prepare a report which requires the supervisory authority, on the other hand, it also needs to prepare financial statements according to the legal regulations in the field of accounting.

In practice, this situation is related to the fact that the insurance company would theoretically prepare regular monthly a very large range of reports, which is time-consuming and cost-intensive. Therefore, currently the biggest problem in the Polish insurance companies is to harmonize these activities in order to minimize unnecessary reporting activities. The key issue, therefore, is to compare the scope of the reports prepared by the Solvency II regulations with existing accounting law in Poland for the insurance business.

The most important differences between these two types of reports indicate:

- Different grouping for investments; in total they are the same, but they must be grouped differently, which is an additional work for the people that these reports will be prepared. While the positive thing is that the information of investors contained in the books can be used for the purposes of Solvency II.

- Much greater detail with the information relating to receivables in the balance sheet under Polish law. The supervisor requires only information about the overall receivables without dividing them into different types.
- Another view of reinsurance. According to accounting law, reassurance it appears as reinsurers' share in many different positions and is dispersed. In a report for the supervision it is recognized in only a few items in total.
- Another recognition of technical provisions. According to Polish law, they are presented with the division on the overall value and listed the reinsurers' participation in them. For the purpose of supervision this is being provided from the standpoint of best estimate and risk margin.
- Lack of information about equity in the supervisory report.

There is no need to make exact operating accounts separately for the purposes of supervision. This does not mean that the information is unnecessary for supervisors, only the data from the financial statements are sufficient. Summing up the common part of the financial statement and supervisory reporting is a balance sheet, and in particular the valuation of assets. On the other hand for the needs of insurance supervision there must be prepared additional information relating to the SCR, which are not needed in the financial statements. The accounting regulations require more information about the results of each activity, as well as cash flows or changes in shareholders' equity.

6. Conclusion

Ernst & Young conducted in April 2014 a study on the readiness of European insurance companies for the implementation of Solvency II [www.biznes.pl; European Solvency II Survey…]. According to the results, nearly 80% of insurers rated that they are ready fully to all the action. The greatest progress in preparing was declared by insurers in the Netherlands, the UK and Scandinavia. France, Germany and Greece are less advanced. Insurers in Poland assessed their preparedness as slightly less than 80% at the end of 2015. These are, however, the most advanced of all the countries of Central and Eastern Europe. European insurers also pointed out that the biggest problems are made by reporting and the preparation of the IT system, with particular emphasis on data quality management system. As one can see, therefore, the issue of reporting for Solvency II is very real.

Comparing the current legislation regarding the financial statement presentation insurance companies in Poland with the requirements of Solvency II, one can draw the following conclusions about the impact of the project on the changes:

- The scope of both reports is different, it is true that rules of balance sheet overlap, but will also require the modification of data. Such a situation could result, especially at the beginning of the implementation of this process, in additional work and costs that will be associated with the necessity of preparing reports for supervisors, which do not coincide with information from the bookkeeping.

- Solvency II will result in a significant expansion of reporting needs. Additional reports prepared for the purposes of supervision may yet also be used for other purposes, for example in the management process. This will be a situation in which the obligation to draw up reports on monitoring needs can be attributed to management accounting.
- Implementation of the project will certainly contribute to increasing the harmonization of accounting and despite the fact that the initial phase of work can be very difficult and expensive, in the future it can give positive results in the greater transparency of the financial data of the Polish market, which will be comparable with other European markets.

The Solvency II project is being implemented and supervised by the Polish Financial Supervision Authority, but there is also another organization called the Polish Insurance Association. It represents the interests of insurers. As part of this association there is a separate Subcommittee of Solvency II in the Economic - Financial Commission. Its main task is to consult and communicate positions on draft delegated acts, guidelines and implementing technical standards. The position of the Polish insurance market was presented at the European forum through consultation of representatives of the Polish government and the comments transmitted through Insurance Europe, which is the equivalent of the Polish Insurance Association.

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